ST 98-0362-GIL 11/30/1998 TELECOMMUNICATIONS EXCISE TAX

The Telecommunications Excise Tax is imposed upon the act or privilege of originating or receiving intrastate or interstate telecommunications in Illinois at the rate of 7% (increased from 5%, effective January 1, 1998) of the gross charges for such telecommunications purchased at retail from retailers. See 86 Ill. Adm. Code Part 495. (This is a GIL.)

November 30, 1998

Dear Mr. Xxxxx:

This letter is in response to your letter dated June 22, 1998. We regret the delay in our response. The nature of your letter and the information you have provided require that we respond with a General Information Letter which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), enclosed.

In your letter, you have stated and made inquiry as follows:

We represent a client who provides network management services that include designing, building and maintaining wide area networks for customers throughout the United States. A wide area network (WAN) is a data communications system that connects a company's central location computers with other company computers or electronic devices in remote locations. The remote locations might be in the same city, another city, another state or even in another country. The WAN is a private data network, using dedicated or priority communications channels, that enables a company to transmit and receive computer generated information among the various connection points along the WAN. For example, E-Mail messages can be sent back and forth between WAN connections points; or a bank could send information from an ATM to a central bank depository to verify an account balance before a cash withdrawal is made; and, employees of a company could transmit and receive computerized information from personal computers to other personal computers or to or from a mainframe computer database.

The client's mission is to help its customers add business value to their organization by (1) building and managing networks that meet the objectives of the customer's business, and (2) allowing the customer's staff to focus on the strategic work of effective information services. Our client makes sure the network is neither under built (too slow) or overbuilt (too expensive). Our client tracks assets to ensure their use is optimized across the network as needs and technologies change. Our client makes sure appropriate security measures are in place to protect proprietary data. The client reduces the risk of technological obsolescence through recommending financing options, such as leasing, that results in off-balance sheet treatment for accounting purposes.

Specifically, our client utilizes a method known as the AIM Approach. (Assessment, Implementation and Management). Services included in the AIM Approach are described as follows:

(1) Network Assessment Services - In the initial phase of the AIM approach, the client develops a network design that meets each customer's needs. An accurate design requires a thorough assessment. This assessment includes analyzing existing network performance and understanding the clients application and business requirements. Specifically, these services include:

> (a) Network analysis which establishes the network's performance baseline and provides design recommendations and information to effectively manage an enterprise network.
>
> (b) Pilot testing, application modeling and performance analysis provides data for platform placement and network design.
>
> (c) Analysis of business requirements to determine service performance needs, integrate business needs with application performance models and provide a cost benefit analysis.

(2) Network Design - Identifying the transport (topology and bandwidth) products and protocol strategy to deliver the desired network performance. Design consists of detailed WAN and network system designs and product, topology specifications.

(3) Network Implementation Services - Included in these services are the following:

> (a) Project Planning and Management - After the network design is established, the implementation plan is developed to include:
>
> > (i) Development of a prioritized timeline to roll out a network.
> >
> > (ii) A team roster listing dedicated team members, responsibilities and contracts.
> >
> > (iii) Site-by-site implementation schedules and procedures which allow for variations by site, but ensure consistency and thereby significantly reduce return visits to sites.
> >
> > (iv) Change management procedures, based on client's field-tested processes or an existing customer process.
> >
> > (v) Documented procedures for all work completed at each site, including floor plan, equipment and circuit information, and client acceptance and sign-off forms.
>
> (b) Procurement and Configuration Services - Based on the customer's network architecture requirements, client acquires all

network products and prepares them for installation. This includes:

(i) Procurement of all products and shipment to client's in-house Network Configuration Center.

(ii) Configuration, staging, and testing based on documented procedures guaranteeing consistency in equipment configuration across the network.

(iii) Packaging and shipment of site specific installation kits to each client site.

(iv) Detailed documentation of product shipped, including models, serial numbers, asset tag numbers (where appropriate) and router software configurations.

(c) <u>On-Site Implementation Services</u> - In the installation phrase, client delivers the network to the customer sites, providing an operable/manageable network. This includes:

(i) Coordination of all circuit installations with the telecommunications carriers.

(ii) Documents which outline the location, type, serial number and warranty information for all customer premise equipment (CPE) as well as circuit numbers and type.

(iii) Installing network components/products and cabling to specified site floor plans.

(iv) Ensuring the network works properly through quality assurance and customer acceptance before leaving a site.

(4) <u>Network Management Services</u> - Included in these services are the following:

(a) <u>Configuration Management</u> - Creating and maintaining an information base that supports other network management disciplines including asset management, change management and maintenance.

(b) <u>Fault Management</u> - Maximizing productivity and minimizing downtime by preventing outages before they occur and rapidly locating and fixing network issues.

(c) <u>Performance Management</u> - Optimizing the return on investment by preventing the productivity losses of underbuilding and the costs of overbuilding a network, and providing ongoing performance evaluation and capacity planning.

(d) <u>Security Management</u> - Providing authentication and access control capabilities, protecting corporate assets (Physical and intellectual) by detecting security violation and testing back-up plans for disaster recovery.

(e) Account Management - Tracking end-user usage patterns and costs and supporting enterprisewide charge-back procedures.

(f) Customized Network Management Solution - Customize management procedures and align expectations. Through this process, expectations are established and a service level agreement is finalized. Tailored to each customer's requirements (monthly, quarterly or semi-annually) reports are generated supplying statistics and requested information pertaining to the services provided.

(g) Support Infrastructure

(i) Client maintains its own Network Management Center to monitor all of the customer's sites at once identifying incidents or troubles before they affect the network.

(ii) On-line documentation in the Network Management Center enables each operator to access any pertinent information regarding each customer's network, such as network diagrams, trouble tickets, stipulated processes and priority levels, and maintenance agreements.

The WANs, which are an integral part of the AIM approach, are currently being designed, built and maintained as data only networks. However, some customers have asked to have voice capabilities added. If this occurs, the network will still remain a private network, but will have both voice and data capabilities. It is not clear whether the voice network could be connected through additional switching to the public switched telephone network. The WANs consist of the customer's central location computers and remote computers, router equipment at each site and communications links (provided by telecommunications carriers), and our client's Network Management Center. The client can provide the WAN to the customer in three different manners:

First, our client provides all services for a single bundled fee. This includes providing the equipment, installation, some or all of the communications links and the monitoring and management services. In effect, the tangible equipment is leased to the customer along with the various services provided. When applicable, our client will charge the customer sales tax on the total amount of the bill. The client purchases the equipment and subcontracted installation services for resale but does not purchase the communications lines for resale, but pays sales or other telecommunication taxes to the carriers. (In Illinois, Maine, and New Jersey we pay tax on all equipment purchased for lease with no separate sales tax charged to our customers. In Louisiana, we pay tax on the equipment and charge an additional rental tax);

Second, the customer purchases the various equipment components and installation outright via cash purchase from our client or directly from a 3rd party vendor. The client charges for monitoring and management services provided for a single bundled monthly fee. Included in those services are the communication links provided by 3rd party telecommunication carriers. The client does not purchase any communications lines for resale, but rather pays sales or other telecommunication taxes to the carriers; and,

Third, our client purchases the equipment for resale, sells it to its parent company, and the parent company then leases it to the customer using an operating lease format. The client charges the customer for installation if it is not written into the lease, and for the monitoring and management services (including communication links) provided for a single bundled fee. The client does not purchase any communications lines for resale, but rather pays the sales or other telecommunication taxes to the carriers. Its parent charges the customer for the leased equipment (and installation, if applicable), including applicable sales tax.

Based on the above, we are seeking your opinion as to what, if any, tax is due with respect to the services we perform for our customer and equipment sold under each of the three described scenarios. Would your answer change if our customer itemized its services and equipment instead of bundling the services and equipment together in its contract and/or billings? Is the client properly paying tax to its telecommunications carriers (AT&T, MCI, etc.) based upon use of the carrier's telecommunications lines? If our client just sells telecommunications links to its customers, how would telecommunications tax be calculated?

Thank you in advance for any help you can provide.

Under the circumstances set forth in your letter regarding the first method your client provides the WAN to its customers, the principles regarding leasing may apply. Please note that the State of Illinois taxes leases differently for Retailers' Occupation Tax and Use Tax purposes than the majority of other states. For Illinois sales tax purposes, there are two types of leasing situations: true leases and conditional sales.

A true lease generally has no buy out provision at the close of the lease. If a buy out provision does exist, it must be a fair market value buy out option in order to maintain the character of the true lease. Lessors of tangible personal property under true leases in Illinois, are deemed end users of the property to be leased. See the enclosed copy of 86 Ill. Adm. Code 130.220. As end users of tangible personal property located in Illinois, lessors owe Use Tax on their cost price of such property. No tax is imposed on rental receipts by the State of Illinois. Consequently, lessees incur no tax liability.

The above guidelines are applicable to all true leases of tangible personal property in Illinois except for automobiles leased under terms of one year or less, which are subject to the Automobile Renting Occupation and Use Tax found at 35 ILCS 155/1 et seq.

As stated above, in the case of a true lease, the lessors of the property being used in Illinois would be the parties with Use Tax obligations. The lessors would either pay their suppliers, if their suppliers are registered to collect Use Tax, or would self-assess and remit the tax to the Department. If the lessors already paid taxes in another state with respect to the acquisition of the tangible personal property, they would be exempt from Use Tax to the extent of the amount of such tax properly due and paid in such other state. See 86 Ill. Adm. Code 150.310(a)(3) enclosed.

Under Illinois law, lessors may not "pass through" their tax obligation on to the lessees as taxes. However, lessors and lessees may make private contractual arrangements for a reimbursement of the tax to be paid by the lessees. If lessors and lessees have made private agreements where lessees agree to reimburse lessors for the amount of the tax paid, then lessees are obligated to fulfill the terms of the private contractual agreements.

A conditional sale is usually characterized by a nominal or one dollar purchase option at the close of the lease term. Stated otherwise, if lessors are guaranteed at the time of the lease that the leased property will be sold, this transaction is considered to be a conditional sale at the outset of the transaction, thus making all receipts subject to Retailers' Occupation Tax.

Under the circumstances set forth in your letter regarding the second and third methods your client provides the WAN to its customers, it appears that Retailers' Occupation Tax is incurred on equipment sales.

Please note that Retailers' Occupation Tax and Use Tax do not apply to receipts from sales of personal services. Under the Service Occupation Tax Act, servicemen are taxed on tangible personal property transferred incident to sales of service. For your general information we are enclosing a copy of 86 Ill. Adm. Code 140.101 regarding sales of service and Service Occupation Tax.

The purchase of tangible personal property that is transferred to service customers may result in either Service Occupation Tax liability or Use Tax liability for the servicemen, depending upon which tax base the servicemen choose to calculate their liability. Servicemen may calculate their tax base in one of four ways: (1) separately stated selling price; (2) 50% of the entire bill; (3) Service Occupation Tax on cost price if they are registered de minimis servicemen; or, (4) Use Tax on cost price if the servicemen are de minimis and are not otherwise required to be registered under the Retailers' Occupation Tax Act.

Using the first method, servicemen may separately state the selling price of each item transferred as a result of sales of service. The tax is based on the separately stated selling price of the tangible personal property transferred. If servicemen do not wish to separately state the selling price of the tangible personal property transferred, those servicemen must use 50% of the entire bill to their service customers as the tax base. Both of the above methods provide that in no event may the tax base be less than the cost price of the tangible personal property transferred. Under these methods, servicemen may provide their suppliers with Certificates of Resale when purchasing the tangible personal property to be transferred as a part of the sales of service.

The third way servicemen may account for their tax liability only applies to de minimis servicemen who have either chosen to be registered or are required to be registered because they incur Retailers' Occupation Tax liability with respect to a portion of their business. Servicemen may qualify as de minimis if they determine that their annual aggregate cost price of tangible personal property transferred incident to sales of service is less than 35% of their annual gross receipts from service transactions (75% in the case of pharmacists and persons engaged in graphic arts production). See, 86 Ill. Adm. Code 140.101(f) enclosed.

This class of registered de minimis servicemen is authorized to pay Service Occupation Tax (which includes local taxes) based upon the cost price of tangible personal property transferred incident to sales of service. They remit the tax to the Department by filing returns and do not pay tax to suppliers. They provide suppliers with Certificates of Resale for the property transferred to service customers.

The final method of determining tax liability may be used by de minimis servicemen that are not otherwise required to be registered under the Retailers' Occupation Tax Act. Servicemen may qualify as de minimis if they determine that their annual aggregate cost price of tangible personal property transferred incident to sales of service is less than 35% of their annual gross receipts from service transactions (75% in the case of pharmacists and persons engaged in graphic arts production). Such de minimis servicemen may pay Use Tax to their suppliers or may self-assess and remit Use Tax to the Department when making purchases from unregistered out-of-State suppliers. Those servicemen are not authorized to collect "tax" from their service customers, nor are they liable for Service Occupation Tax. It should be noted that servicemen no longer have the option of determining whether they are de minimis using a transaction by transaction basis.

It is not clear as to whether sales of telecommunications are being made. The following general discussion of the Telecommunications Excise Tax is for your information. The Telecommunications Excise Tax is imposed upon the act or privilege of originating or receiving intrastate or interstate telecommunications in Illinois at the rate of 7% (increased from 5%, effective January 1, 1998) of the gross charges for such telecommunications purchased at retail from retailers. Please see the copy of 86 Ill. Adm. Code Part 495, enclosed. This tax must be collected from customers by retailers maintaining a place of business in this State. See 35 ILCS 630/5.

Pursuant to Section 495.100(a), "gross charge" means the amount paid for the act or privilege of originating or receiving telecommunications in this State and for all services and equipment provided in connection therewith by a retailer, valued in money, whether paid in money or otherwise, including cash, credits, services and property of every kind or nature, and shall be determined without any deduction on account of the cost of such telecommunications, the cost of material used, labor or service cost or any other expense whatsoever.

A retailer may provide services to customers which are not provided in connection with originating or receiving telecommunications. If such services are not necessary for or directly related to the retailer's provision of telecommunications to customers and the charges for such services are disaggregated and separately identified from other charges, the charges need not be included in "gross charges."

I hope this information is helpful. The Department of Revenue maintains a Web site which can be accessed at www.revenue.state.il.us. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of the enclosed copy of Section 1200.110(b).

Very truly yours,

Melanie A. Jarvis
Associate Counsel

MAJ:msk
Enc.